

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

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from: Associate Area Counsel, LM:HMT, Cleveland, Ohio

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subject: **Aerospace ISP**  
**Intranet Website FAQs II and III**  
**U.I.L. Nos. 451.00-00; 460.00-00; 993.03-00**

This memorandum responds to your requests for assistance dated December 20, 2001, and January 28, 2002. This memorandum should not be cited as precedent.

You requested that we review certain "Frequently Asked Questions" (FAQs) to be posted to the Aerospace ISP IRS Intranet website. Our recommended revised FAQs are provided below. These revisions are provided pursuant to the 10-Day Post Review procedures of CCDM (35)3(19)4(4), as these FAQs are limited to primarily well-settled principles of law. Accordingly, a copy of this memorandum has also been provided to the Office of Chief Counsel for review and comment. We will advise you of their comments as soon as they are received.

Q.1. What are progress payments and advance payments?

A.1. Title 48 of the Code of Federal Regulations contains the Federal Acquisition Regulations System ("FAR"). FAR 32.102 - Description of Contract Financing Methods - sets forth the various methods by which federal contractors receive payment for contractual performance. This includes advance payments, progress payments based on costs as work progresses, and progress payments based on percentage or stage of completion. Advance payments, as the term suggests, are paid in advance of performance. See, generally FAR 32.4; Treas. Reg. Sec. 1.451-5(a). Progress payments are paid upon completion or attainment of certain predetermined milestones or phases of

the contract. See, generally FAR 32.5.

Q.2. When should progress payments and advance payments received pursuant to a long-term government contract be recognized?

A.2. The proper time for recognizing income under a long-term contract depends upon the method of accounting employed by the taxpayer. Generally, a contract which satisfies the section 460(f) definition of a long-term contract, i.e., a contract for the manufacture, building, installation, or construction of property that is not completed within the tax year in which entered, must use the percentage of completion method ("PCM") of accounting. Section 460 does not apply to long-term contracts which do not meet this definition, e.g., service contracts, or contracts which were entered into prior to March 1, 1986, the effective date of section 460. Long-term contracts which are not subject to section 460 continue to be subject to the rules which existed prior to enactment of section 460. See Treas. Reg. Sec. 1.451-3. [Treas. Reg. Sec. 1.451-3 was removed on January 10, 2001 by T.D. 8929.]

Taxpayers who entered long-term contracts (as defined in Treas. Reg. Sec. 1.451-3(b)(1)(i)) prior to March 1, 1986, may account for income and expenses under PCM, the completed contract method ("CCM"), or any other method, e.g., the accrual method, provided that such method clearly reflects income. Treas. Reg. Sec. 1.451-3(a)(1). The definition of a long-term contract under Treas. Reg. Sec. 1.451-3(b)(1)(i) is essentially the same as that under section 460(f).

The receipt of an advance payment or a progress payment has no impact on the timing of income recognition under PCM or CCM. Although a PCM taxpayer recognizes income over the life of the contract, the receipt of an advance payment or progress payment nonetheless does not impact the timing of income recognition, because income is recognized according to a formula, which is not based upon payments received. See section 460(a) and (b). Under CCM, income and expense recognition is deferred until contract completion. Treas. Reg. Secs. 1.460-4(d) and 1.451-3(d)(5).

A taxpayer who accounts for income from long-term contracts under the accrual method must apply the "all events" test to determine the proper time for recognizing income. Under the all events test, income is recognized when the taxpayer has a

fixed right to the income and the amount thereof can be determined with reasonable accuracy. Treas. Reg. Secs. 1.446-1(c)(1)(ii) and 1.451-1(a). A taxpayer's right to income is fixed when: a) the required performance takes place; b) payment is due; or (c) payment is made, whichever happens first. Rev. Rul. 80-308, 1980-2 C.B. 162, 163.

Pure service contracts subject to the Federal Acquisition Regulations ("FAR") may provide for progress payments as the taxpayer accomplishes various contract "milestones." In such cases, an accrual basis taxpayer's right to a progress payment becomes "fixed" when it reaches a milestone. On the other hand, progress payments received by an accrual basis taxpayer in connection with a production contract subject to the FAR may not become fixed until the payment is "liquidated." A progress payment is "liquidated" upon acceptance and delivery of the property contracted for by the government. Prior to liquidation, the contractor may be required to refund the portion of unliquidated progress payments received if the contract is terminated for default or convenience of the government. FAR 52.232-16(h). Once the property has been delivered and accepted, the progress payments received in connection with such property are considered liquidated, and not subject to refund. FAR 32.503-8. Such payments may be viewed as a form of non-taxable financing, to the extent they are subject to possible refund by the taxpayer. The analysis underlying the decision in Consolidated-Hammer Dry Plate & Film Co. v. Commissioner, 317 F.2d 829 (7th Cir. 1963) supports this position.

Q.3. May a taxpayer use a non-long-term contract method to account for services that directly benefit a long-term contract simply because services are considered a non-long term contract activity?

A.3. Contracts which satisfy the definition of a long term contract under section 460(f) must generally use PCM. A pure service contract, even though not to be completed within the year entered, does not satisfy the definition of a long-term contract because it does not constitute an obligation to manufacture, build, install or construct property. G.C.M. 39803. Thus, a contract to provide architectural, design, engineering, or construction management services by a firm engaged solely in such activity cannot be accounted for under a long-term contract method. Treas. Reg. Sec. 1.460-1(d)(2).

On the other hand, section 460(c)(1) provides that all direct and indirect costs that directly benefit, or are incurred by reason of, a long-term contract activity of a taxpayer shall be allocated to the contract. This allocation will not be limited to just those activities involving the actual building, installation, construction or manufacturing of the property. Rather, if the taxpayer performs a non-long term contract activity that is considered incident to or necessary for the manufacture, building, installation or construction of the subject matter of one or more of the taxpayer's long term contracts, the taxpayer must allocate the costs attributable to that activity to such contract(s). Treas. Reg. Sec. 1.460-5(f)(2). Thus, income and expenses attributable to engineering or similar services that enable a taxpayer to construct or manufacture the subject matter of a long-term contract must be accounted for as part of the long-term contract, since such services directly benefit or are performed by reason of the taxpayer's building, installation, construction, or manufacturing obligation. G.C.M. 39803.

Q.4. The model progress payment contract subclause set forth in Federal Acquisition Regulation 52.232-16(d) provides that title to the property identified therein shall pass to the government upon the date of the contract. Could it be argued that a taxpayer who accounts for its manufacturing contracts under the accrual method has taxable income upon receipt of a progress payment?

A.4. As explained above, progress payments received in connection with a manufacturing contract remain "unliquidated" until delivery to and acceptance by the government of the contracted for item. FAR 32.503-8. Although FAR 52.232-16(d) provides for passage of title for the items at the time of contract, this tends to be viewed as the granting of a security interest to the government in the property rather than a transfer of ownership thereof. PLR 8517001. Moreover, FAR 52.232-16(d) does not pass the risk of loss in connection with the property. Rather, risk of loss is generally passed from the contractor only upon delivery and acceptance (liquidation) by the government. See FAR 52.232-16(e). Given this, it seems unlikely that "title passage" pursuant to FAR 52.232-16(d) would be found to be a basis for accruing income with respect to an unliquidated progress payment.

Q.5. How are retainages or holdbacks accounted for under the accrual method?

A.5. Progress payments otherwise payable under a long-term government contract may be subject to a holdback or retainage. See, e.g., FAR 52.232-5(e). In the case of a long-term contract accounted for under section 460, if the contractor reasonably expects to receive the holdbacks and retainages, then it must include them in the total contract price amount, even if the all events test has not been met. Treas. Reg. Sec. 1.460-4(b)(4)(i)(A) and (B); Notice 89-15, 1989-1 C.B. 634, Q&A 27. Under the accrual method, if the holdback or retainage is not to be paid until the satisfaction of a condition precedent, e.g., delivery and acceptance by the government, then recognition of holdback or retainage amount would not be proper until the condition is satisfied. Rev. Rul. 69-314, 1969-1 C.B. 139.

Q.6 May a taxpayer defer recognition of "provisional billing" amounts until actual billing rates are finally determined?

A.6. Cost reimbursement contracts are a category of contracts which provide that the contractor will be paid for allowable incurred costs to the extent prescribed in the contract. FAR 16.301-1. This group of contracts includes "cost plus" contracts in which the contractor receives a fee (which can be based on an incentive formula, an award based on judgmental evaluation by the government, or a fixed amount) in addition to the cost reimbursement. FAR 16.304 through 306.

Indirect costs incurred in connection with a cost reimbursement contract are typically reimbursable at "provisional billing" rates established by the government, subject to adjustment when the final rates are established. These final billing rates may also be prospectively or retroactively revised by mutual agreement, at either party's request, to prevent substantial overpayment or underpayment. FAR Sec. 52.216-7(e).

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. Taxpayers who account for their cost reimbursement type contracts under the accrual method are required to recognize income when the right thereto is fixed and its amount can be determined with reasonable accuracy. Treas. Reg. Sec. 1.446-1(c)(1)(ii) and 1.451-1(a). When an amount of

income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. Treas. Reg. Sec. 1.451-1(a). Where a taxpayer receives income without restriction as to its disposition, use or enjoyment, it is required to report such income in the taxable year of receipt even though it has been received subject to a contingent liability to return some part of it. Rev. Rul. 66-347, 1966-2 C.B. 196. The fact that provisional billing amounts received by an accrual basis taxpayer may be subject to adjustment in a subsequent year when final billing rates are determined will not preclude the taxpayer from taking the provisional amounts into income in the year received. See, Rev. Rul. 81-176, 1981-2 C.B. 112.

Q.7. Does the definition of airframe include the engines and thrust reversers?

A.7. Whether the engines and thrust reversers were included in the definition of airframe was important to the court's consideration in General Electric v. Commissioner, 245 F.3d 149 (2nd Cir. 2001). The court found, based in part upon the stipulation of the parties, that the engines at issue in that case were separate and distinct from the airframe. General Electric v. Commissioner, 245 F.3d at 157-159. However, the court's opinion was less definitive as to the thrust reversers, remanding the thrust reverser portion of the case to the Tax Court for further consideration. General Electric v. Commissioner, 245 F.3d at 159.

The Federal Aviation Administration regulations offer a more detailed definition of an airframe, and do not include the engines or reversers in the items composing an airframe:

Airframe means the fuselage, booms, nacelles, cowlings, fairings, airfoil surfaces (including rotors but excluding propellers and rotating airfoils of engines), and landing gear of an aircraft and their accessories and controls.

14 CFR Sec. 1.1 (2000).

Q.8. When might a taxpayer prefer to report income under the accrual method rather than PCM?

A.8. Under PCM, income is reported based upon the PCM equation:

Total Contract					
Costs incurred					Income
through the end		Total		Gross Income	to be
<u>of the tax year</u>	x	Contract	-	Reported in	= Reported
Estimated total		Price		Prior Years	in
Current					
contract costs					Year

Section 460(a) and (b); Treas. Reg. 1.451-3(c). The taxpayer is required to include in the "Total Contract Price" amount any contingent amounts, such as bonuses, awards, incentive payments, and amounts in dispute, as soon as the taxpayer can reasonably predict that the amounts will be earned, even if the all events test for accrual purposes would not have been met with respect to such items. Treas. Reg. Sec. 1.460-4(b)(4)(i)(A). Accordingly, taxpayers may prefer the accrual method when these types of income are present, as income recognition may be required under PCM when it is not required under the accrual method.

Q.9. What is a Work Breakdown Structure?

A.9. The Work Breakdown Structure ("WBS") defines the system to be developed or produced for the government. It displays the system as a product-oriented family tree composed of hardware, software, services, data, and facilities. It relates the elements of work to each other and to the end product. It is a product-based approach to program planning which ensures that all products are identified and defined clearly before proceeding with planning the activities or processes required for them to be produced. See the Department of Defense ("DoD") handbook entitled Work Breakdown Structure, MIL-HDBK-881 at

[http://www.acq.osd.mil/pm/newpolicy/wbs/mil\\_hdbk\\_881/mil\\_hdbk\\_881.htm](http://www.acq.osd.mil/pm/newpolicy/wbs/mil_hdbk_881/mil_hdbk_881.htm)

for examples of a WBS.

Q.10. How can I use a WBS in the examination of an aerospace company?

A.10. A WBS can be used in the examination of the research

credit claimed by a taxpayer in connection with a specific contract. The WBS provides an overview of the relationship of the various tasks to be performed under a contract. The WBS assigns a reference number to each of these tasks. The WBS number is included in the description of the task set forth in the Statement of Work ("SOW"). Through the WBS number, the examiner can locate the SOW task description corresponding to the task identified in the WBS. The SOW task description will assist the examiner in determining whether the task satisfies the definition of qualified research for purposes of section 41. The following is an example of the WBS-SOW relationship taken from DoD's Work Breakdown Structure handbook:

Requirement	WBS Elements	SOW Tasks
System Specification 1000 Air Vehicle 1100 Airframe 1110 Wing	1000 Air Vehicle 1100 Airframe 1110 Wing	3.1 Air Vehicle (WBS 1000) Design, develop, produce and verify, complete air vehicles defined as airframe propulsion, avionics and other installed equipment.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. Also, if you have any questions, please feel free to contact the undersigned at (216) 522-3380, ext. 3106.

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